ICAEW
REPRESENTATION 89/23

OIL AND GAS FISCAL REGIME CALL FOR EVIDENCE

Issued 11 September 2023

ICAEW welcomes the opportunity to comment on the oil and gas fiscal regime review call for evidence published by HM Treasury on 31 July 2023 a copy of which is available from this link.

For questions on this response please contact us at representations@icaew.com quoting REP 89/23.

ICAEW welcomes the review of oil and gas fiscal regime, given the role the sector plays in the economy today and the challenges the oil and gas industry will face as we transition to net zero. ICAEW is supportive of a tax system that is simplified for the sector; however this should not lead to extended reliance on or encourage further investment in fossil fuels for energy security, and the government should look at ways to incentivise renewable energy investment to secure a net zero, energy secure future.

This ICAEW response of 11 September 2023 reflects consultation with the Sustainability Committee and Tax Faculty. Sustainability describes a world of thriving economies and just societies based on what nature can afford. Members in practice, in business and private individuals all have a role to play if sustainability goals are to be met. The work being undertaken by ICAEW in this area is to change behaviour to drive sustainable outcomes.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 166,000 chartered accountant members in over 146 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

ICAEW
Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK
T +44 (0)20 7920 8100 F +44 (0)20 7920 0547 icaew.com

The Institute of Chartered Accountants in England and Wales (ICAEW) incorporated by Royal Charter (RC000246)
Registered office: Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK

KEY POINTS

Energy security

1. With concern to energy security, the focus of government should be on incentivising investment in renewable energy alongside decarbonising oil and gas, rather than the overreliance on oil and gas to meet current and future energy demand. Whilst we recognise the role oil and gas plays in the transition and the short to medium term reliance on fossil fuels to meet energy demand, the fiscal regime should not skew investment decisions that may extend that reliance and lock the UK into high-carbon energy infrastructure.
2. The OBR's Fiscal risks and sustainability report from July 2023 illustrates how dependent the UK is on imported energy, especially imported gas which makes up around half of the amount consumed in the UK today. Even though gas prices have now fallen back from a height of £6.40 a therm in August 2022, they remain twice their historical average following Russia's invasion of Ukraine and are expected to stay at that level for the next few years.
3. The International Energy Agency (IEA) suggests that roughly 40% of the oil and gas supply chain has synergies with offshore wind, with both relying on a limited availability of ports, vessels and workforce. Attempts to boost both sectors at the same time will create competition between increasingly scarce resources, limiting availability and drive costs up.
4. Oil and gas fields operating in the North Sea currently supply around half of the UK's gas needs. Those fields and the new licenses announced on 31 July are not owned by the UK, but by the license-holders which are wholly made up of multinational, private equity, and state-backed firms, meaning this does not guarantee supply to the UK market. Exports will continue with any new production that is brought online - currently 80% of North Sea oil is exported because there is little demand from the country's refineries for UK crude oil. But even much of the gas, where there is domestic demand, is sold overseas.
5. Policy movements that support the oil and gas sector will have a limited impact on improving energy security nor will they protect consumers from volatile commodity pricing determined by international benchmarks. Furthermore, such policies are more likely to stimulate demand for scarce supply-chain resources, increase inflationary pressures and reduce capacity for offshore wind projects, which risks compounding exposure to price volatility and sustained emissions by slowing the progress of offshore wind – a resource that the UK can take advantage of in abundance, is clean and comparatively cheap. Indeed, the OBR report mentioned above notes that with gas prices at their current rate, renewable energy sources have now become cheaper than gas for the first time.

Investment opportunities and low carbon technology

6. The sector has an opportunity to pivot operations from extracting hydrocarbons to green and blue hydrogen production. Hydrogen is an obvious fit for oil and gas companies due to their experience in natural gas and the potential growth opportunities of the sector – the World Bank have reported from 2020 to 2021 hydrogen production market was valued at $130 billion and is forecast to grow up to 9.2% annually to 2030. According to the IEA, clean hydrogen can support high-emitting sectors to decarbonise, such as long-haul transport, chemicals, iron and steel, improve air quality, and is one of the leading options for storing energy from renewables.
7. One caveat is that current hydrogen production is largely from fossil fuels and therefore to produce at scale in line with net zero, a clean energy future requires both capture of CO2 and greater supplies of hydrogen from clean electricity. The UK Government in collaboration with industry can work to unlock investment in this by ensuring regulations are not an unnecessary barrier. An example of a project that could be replicated by other companies is BP's HyGreen Teesside, aiming to be the biggest green hydrogen production facility in the UK.

Barriers to decarbonising

8. A report published by City & Guilds and EngineeringUK in July cited that a lack of skills and training for workers to transition to low-carbon roles as well as the low level of awareness of these opportunities among energy workers were key barriers. Only a third of energy workers feel they have the skills they need to succeed in meeting the future demands of the sector, a quarter felt they didn't know how to access training and an astonishing 60% believe the move to decarbonise power systems will put their jobs at risk by 2025. Further engagement with the sectors workforce, possibly through trade bodies and professional networks, could help bridge the awareness gap and help connect workers with the training available to them to develop into low carbon roles.
9. Furthermore, a lack of long-term planning from the government to decarbonise the power sector makes it difficult for sector actors to invest in net zero aligned R&D. There have been great improvements in the last 20 years with the renewable share of electricity-generating capacity rising from under 5% in 2020 to over 45% in 2021. However, whole-economy investment in low carbon technologies in 2022 fell by 0.2% of GDP in the UK. UK government investments in green technologies remain behind the OBR's central scenario for what could be needed to transition to net zero by 2050. Investment in renewables varies and is still relatively low in comparison to other capital expenditure and investments. Clearer government energy policies with commitments to renewables would be provide positive signals to companies to increase spend on renewables. In comparison to the EU, the UK also had less funding (such as grants and financing) available for the renewables.
10. We recognise that the Department for Energy Security and Net Zero (DESNZ) made less progress on establishing a long-term delivery plan due to a shift in focus to respond to immediate challenges of energy supply and cost of consumer bills. The UK Government have set an ambitious target to decarbonise the electricity system by 2035 but has not addressed the increased demand for electricity required if we move away from oil and gas-based heating systems. We recommend DESNZ turn their attention to producing a detailed plan with interim targets and delivery mechanisms to achieve the 2035 target to provide clarity to system actors and enable them to invest in decarbonisation activities that align with the delivery plan. Offshore Energies UK (OEUK) published their 2035 supply chain roadmap in July detailing the potential for the offshore energy sector, which includes oil and gas operators and wind developers, to transition to net zero through structured investment across whilst securing economic growth for the UK. Within this roadmap they call for far-sighted policy and stronger engagement between government, regulators, industry and financiers to deliver this roadmap.
11. The OBR also pointed out in its report that continuing our dependence on gas at the current level could, in an adverse scenario, be as expensive fiscally as completing the transition to net zero. It considers a stylised scenario in which the UK's reliance on gas remains unchanged and adverse shocks in global gas prices, of a similar magnitude to that experienced last year, recur every decade. If fiscal policy responds in a similar manner to protect households and businesses from equivalent rises in retail prices, these shocks could cost the Exchequer between 2 and 3 per cent of GDP per year. Taking account of additional debt interest costs and the impact on economic activity, such recurring gas price spikes would add around 13 per cent of GDP to public debt by 2050-51. This is about twice as much as the 6 per cent of GDP central estimate for the total cost of public investment to complete the transition to net zero by the middle of the century.
12. In short, it will be cheaper in the long run for the UK to transition away from fossil fuels sooner rather than later.

SUPPORT FOR DECARBONISATION OF THE ENERGY SECTOR THROUGH THE FISCAL REGIME

13. We set out below details of changes to the tax regime that could be introduced to encourage investment in green technologies and cleaner energy production.

Reform to the R&D tax relief regime

14. HMRC could provide more guidance on the types of R&D projects in the renewables sector it would expect to qualify, thereby increasing more certainty in the claims process.
15. The government is concerned about the validity of claims being made by companies in sectors that would not traditionally undertake a great detail of R&D (eg, the restaurant sector). By focusing its guidance around specific sectors it would like to promote, this would give a clearer indication which types of projects would qualify and those which HMRC has denied relief for.
16. The renewables sector could also be made eligible for the higher tax credit available to R&D-intensive companies (irrespective of the level of R&D intensity in the period concerned). This would provide additional financial incentives for those companies most in need, without creating any unnecessary complexity within the regime.

Capital allowances treatment of preliminary studies for renewables projects

17. The tax treatment of preliminary surveys and other studies relating to capital projects has always been uncertain and this was highlighted in a recent case, *Gunfleet Sands Limited and others v HMRC*, When the case was heard at the First Tier Tribunal, preliminary costs were considered partly allowable and partly unallowable, depending on where they sat within a split of three categories:
    - Studies proposing no mitigations and therefore having no impact on the design/construction of the assets;
    - Studies impacting the design/construction but the changes proposed were not ‘necessary’ (eg, they related to the type of lighting on the wind turbines); and
    - Studies impacting the design/construction in a way that impacted the operational ability or effectiveness.

18. The expenditure deemed not to be qualifying under the capital allowances regime was also not allowable as a revenue deduction as it was considered to be capital in nature, despite not relating directly to the assets concerned. Hence, no form of tax relief was available for these costs.
19. This can be a particular stumbling block for renewable energy projects like wind farms where work is required to establish the impact of the project on the local environment, including metocean, geophysical and geotechnical studies. Greater clarity on the tax treatment available would therefore be most welcome.
20. In particular, it would be helpful if costs of this type could be considered part of the overall capital project and therefore eligible for capital allowances. This would be particularly beneficial from a cashflow perspective now that full expensing and the 50% allowance for special rate pool assets are in place.
21. The government could specify the types of projects that are eligible (eg renewable energy) to limit the cost to the Exchequer. This would provide much -needed funds to the renewables sector as well as providing certainty over tax treatment which can then be factored into investment plans.

Redesign of the fiscal regime for oil and gas

22. The most significant change that could be made in this area would be to consolidate the three regimes (ring fence corporation tax (RFCT), supplementary charge (SC) and petroleum revenue tax (PRT)) into one regime.
    - Given the rate of PRT has been set permanently to 0% since 1 January 2016, there seems little point still having it on the statute book.
    - The differences in the tax base of the RFCT and SC could be eliminated and amalgamated into one tax with a rate of 40%.

23. Aligning the SC with RFCT would restore deductibility of finance costs for the former but remove the further investment allowance available to income generating projects.
24. To manage expectations, existing projects could retain these allowances under grandfathering rules, but any new projects would be ineligible.
25. In response to question 21, it is difficult to see how precisely the government could plan for future energy price shocks in a scenario that is still heavily reliant on fossil fuel energy revenues. In principle, we do not support the introduction of new taxes to tackle short term issues, but we understand the need for the government to respond quicky to last year's energy crisis by introducing the energy profits levy. Perhaps the levy could remain on the statute book but be set at 0% until such time as it is needed again rather than needing to reintroduce it.
26. An alternative approach would be to increase the rate of RFCT temporarily, but we feel that this would be harder to achieve from a legislative standpoint. Maintaining a separate levy also makes it clear that this is in place to fund temporary spending needs.
27. We also observe that if in the long term, petroleum revenues gradually fall away, it will be harder to use the oil and gas sector as a source of government revenue in times of need. However, by investing in green local energy, we envisage that such needs are less likely to be caused by changes in energy prices which the UK will be able to control more easily.